NOTE

This Microfiche meets the quality requirements of the American National Standard for Microfiche of Documents (ANSI PH5.9-1975). However, because of imperfections in the document from which it was made, it contains images that are illegible or difficult to read. The source document for this microfiche is the best copy that could be obtained prior to filming.

Congressional Information Service
Washington, D.C.

Joint Committee on Taxation
July 11, 1989
JCX-30-89

POSSIBLE MODIFICATIONS OF H.R. 1864 RELATING TO NONDISCRIMINATION REQUIREMENTS UNDER SECTION 89

Present Law

Nondiscrimination rules; in general

Under present law, the nondiscrimination rules of section 89 apply to certain types of fringe benefit plans, including employer-provided health plans.[1] The section 89 requirements can be satisfied by meeting either a 4-part test or a 2-part test. An employer is not required to test under both methods; the employer elects which method to apply.

The following requirements apply under the 4-part test. First, at least half of the employees eligible to participate in the plan must be rank and file employees. This test is designed to limit the tax-favored treatment of plans primarily covering highly compensated employees (e.g., executive-only plans).

The second requirement is that at least 90 percent of the rank and file employees must have available to them a benefit at least half as valuable as the most valuable benefit available to any highly compensated employee. This test is designed to ensure that a significant percentage of rank and file employees have a minimum benefit available to them.

The third requirement is that the value of coverage received by rank and file employees must be at least 75 percent of the average value of coverage received by highly compensated employees. This test is designed to ensure that rank and file employees actually receive a significant portion of the tax benefits spent for health coverage.

Fourth, the plan may not contain any provision relating to eligibility to participate that discriminates in favor of highly compensated employees (the nondiscriminatory provision test). This is a subjective test and is intended to be

---

[1] The provisions of section 89 were adopted in the Tax Reform Act of 1986 (1986 Act), and were modified in the Technical and Miscellaneous Revenue Act of 1988 (1988 Act).

J862-44

applied in situations that are not measured by the numerical tests.

Under the 2-part test, which was designed primarily for small employers, the following requirements must be satisfied. First, at least 80 percent of the employer's rank and file employees must be covered by the plan (or group of aggregated plans). The second requirement under the 2-part test is that the plan must satisfy the nondiscriminatory provision test.

If an employer's plan does not meet one of the nondiscrimination tests, then the highly compensated employees must include in income the value of coverage received (e.g., insurance premiums) in excess of the maximum amount that could be received if the nondiscrimination rules were satisfied.

Excludable employees; separate testing

Certain employees are disregarded in applying the nondiscrimination tests. In general, the employees who may be excluded are (1) employees who normally work less than 17-1/2 hours per week (i.e., part-time employees), (2) employees who normally work less than 6 months during a year (i.e., seasonal employees), (3) employees under age 21, (4) employees who have not completed a minimum service requirement (i.e., 6 months in the case of core health coverage and 1 year in the case of other benefits) and (5) nonresident aliens.

In general, employees who are covered under a plan of another employer (e.g., a plan of the spouse's employer) may be disregarded in applying the nondiscrimination tests. In addition, under special rules, family coverage may be tested separately from other coverage and only by taking into account those employees with families. Under these rules, an employer's plans will not fail the nondiscrimination tests simply because more highly compensated employees have families than do rank and file employees.

Highly compensated employees

For purposes of the nondiscrimination requirements, a highly compensated employee is generally defined as an employee who, during the year or the preceding year, (1) was a 5-percent owner of the employer, (2) received compensation in excess of $75,000 (indexed), (3) is an officer of the employer and received compensation in excess of $45,000 (indexed), or (4) received compensation in excess of $50,000 (indexed) and was in the top-paid 20 percent of employees. In lieu of calculating the top-paid 20 percent of employees, the employer may elect to treat all employees with compensation in excess of $50,000 (indexed) as highly

compensated employees. An employer is treated as having at least one officer even if that officer does not have compensation in excess of the $45,000 limit.

Qualification rules

In addition to the nondiscrimination rules, section 89 contains minimum requirements for health plans (and certain other types of plans). These rules require that a plan (1) be in writing, (2) be legally enforceable, (3) be maintained for the exclusive benefit of employees, and (4) be intended to be maintained indefinitely. In addition, employees must be given reasonable notification of plan terms. If an employer's plan fails to satisfy the qualification rules, all employees participating in the plan must include in income the value of benefits (e.g., reimbursements) received under the plan.

Description of H.R. 1864

H.R. 1864, introduced by Chairman Rostenkowski and others on April 13, 1989, makes substantial revisions to section 89. The bill is intended to reduce significantly the recordkeeping and data collection requirements of section 89 while retaining the policy objectives of the nondiscrimination rules.

Nondiscrimination test

The bill replaces the section 89 nondiscrimination rules for health plans with a single simplified test. In general, an employer's health plan passes this test if the plan contains no provision that discriminates in favor of highly compensated employees and the plan satisfies the following requirements:

(1) at least one plan or a group of plans providing primarily core health coverage is available to at least 90 percent of the employer's nonhighly compensated employees at an employee cost of no more than $10.00 per week (i.e., $520 per year) in the case of individual coverage, or $25.00 per week (i.e., $1,300 per year) in the case of family coverage (i.e., coverage of the employee and the employee's family); and

(2) the maximum amount of employer-provided coverage that may be excluded from the income of any highly compensated employee is not more than 133 percent of the employer-provided coverage made available to 90 percent of the nonhighly compensated employees.

The first part of the test is referred to as the

"eligibility test", and the second part is referred to as the "benefits test".

Eligibility test

If the employer fails to satisfy the eligibility test, then the value of all health coverage provided to highly compensated employees is includible in the taxable income of the highly compensated employees. For purposes of the limit on mandatory employee contributions (i.e., employee cost) under the eligibility test, amounts paid through salary reduction are treated as an employee contribution. The dollar limits on mandatory employee contributions are indexed for changes in average wage growth.

As under present law, the bill provides that the employer-provided coverage under a plan may be excluded from the taxable income of a highly compensated employee only if the plan does not contain any provision that (by its terms, operation, or otherwise) discriminates in favor of highly compensated employees. The purpose of the nondiscriminatory provision requirement is to preclude executive-only plans and other inherently discriminatory practices.

Benefits test

Under the benefits test, the maximum coverage that a highly compensated employee may exclude from income generally is 133 percent of the value of the employer-provided employee-only coverage that is taken into account in satisfying the 90-percent test. However, if a highly compensated employee elects family core coverage, and if the employer maintains a plan that provides family coverage that meets the requirements under the bill for the 90-percent test, then the maximum tax-favored coverage is increased. The maximum coverage for such an employee is 133 percent of the value of the employer-provided benefit relating to family coverage that would otherwise satisfy the 90-percent test if family coverage were separately tested.

Any employer-provided coverage received by a highly compensated employee in excess of the level of employer-provided coverage that meets the benefits test is includible in the taxable income of such employee.

For purposes of determining the value of the employer-provided benefit received by highly compensated employees under the benefits test, the bill treats salary reduction as employer contributions.

In determining the value of the employer-provided benefit under a plan for purposes of the benefits test, the bill retains present law, including the rules enacted as part of the 1988 Act. Thus, for example, as under present law, an

employer may use premium cost as determined under the health care continuation rules, or can use any reasonable valuation method in lieu of employer premiums until after the issuance of valuation rules by the Secretary. In addition, the special rule for valuation of benefits under multiemployer plans applies.

Election not to test

Under the bill, an employer may elect to forego testing under the nondiscrimination requirements and instead may include the employer-provided benefit for health coverage as taxable income on the W-2 of highly compensated employees.

Part-time employees

Under the bill, employees who normally work less than 25 hours a week are disregarded for purposes of the nondiscrimination tests (compared with 17.5 hours under present law). Mandatory employee premiums may be proportionately increased with respect to those employees that normally work less than 30 hours per week. In such a case, for purposes of the benefits test, the part-time employee is considered as eligible for the same employer-provided coverage as a full-time employee (even though the value of the employer-provided coverage is reduced because the employee pays more for the coverage).

Leased employees

Under the bill, an employer may disregard a leased employee if the leasing company certifies to the employer that such employee has available a core health plan meeting the limitations on mandatory employee contributions contained in the eligibility test. This rule, like the rule in the pension plan area, is only available if leased employees do not constitute more than 20 percent of the employer's nonhighly compensated workforce.

Employees covered by a collective bargaining agreement

The bill provides that plans maintained pursuant to collective bargaining agreements are tested separately. The rule is to be applied on a bargaining unit by bargaining unit basis.

Former employees

As under present law, the nondiscrimination tests are applied separately to former employees of the employer. The bill delays the application of section 89 to former employees for one year, to 1990. In addition, generally no employee who separates from service prior to January 1, 1990, is to be considered in determining whether the employer meets section

89 with respect to its former employees.

Definition of highly compensated employee

The bill amends the definition of who constitutes a highly compensated employee for purposes of section 89. Under the bill, officers with compensation not in excess of $45,000 will not be considered highly compensated employees.

Plans other than health plans

The bill generally provides that the nondiscrimination rules in effect prior to the Tax Reform Act of 1986 apply to group-term life insurance. The nondiscrimination rules contained in section 129 as amended by the Tax Reform Act of 1986 apply to dependent care assistance programs.

Failure to comply with qualification rules--excise tax on employer

The bill replaces the present-law sanction for failures to satisfy the plan qualification requirements of section 89 with an excise tax on the employer. The excise tax is equal to 34 percent of the cost to the employer relating to the coverage that failed the qualification requirements. Generally, the cost to the employer is calculated as under the health care continuation rules relating to all coverage under the failed plan.

Effective date

The bill is effective for plan years beginning after December 31, 1989. However, the employer may use either present law or the new rules for 1989. The rule relating to the sanction under the qualification rules and the rule allowing an employer to forego testing are effective for plan years beginning after December 31, 1988.

Description of Possible Modifications to H.R. 1864

Nondiscrimination rules; in general

The possible modification would modify: (1) the group of employees to whom an affordable plan must be available under the 90-percent eligibility test by providing that an affordable plan must be available to at least 90 percent of the employer's employees; and (2) the definition of an affordable plan.

Under the possible modification, a plan generally would be considered affordable if it is available at an employee cost of no more than 50 percent of the total cost of the plan in the case of employee-only coverage, or 50 percent of the

total cost of the plan in the case of family coverage (including coverage for the employee). An additional affordability rule would apply in the case of low-income employees. In the case of an employee with annual compensation from the employer of less than $20,000, a plan would not be considered affordable unless the total annual cost to the employee for employee-only coverage does not exceed $1000.

With respect to an employee with compensation from the employer of less than $20,000 per year, family coverage would not be considered affordable unless the total annual cost to the employee for such coverage does not exceed $2,000 per year.

Special rules for small employers

The amendment would provide special rules for small employers. A small employer would be defined for purposes of the amendment as an employer with 20 or fewer employees (determined on the first day of the plan year).

Alternative nondiscrimination test

The amendment would provide an alternative nondiscrimination test for small employers. This alternative test would not be available to professional service organizations.

The alternative test would be satisfied if the following requirements are met:

(1) The employer maintains a single health program available on the same terms and conditions to 100 percent of the nonexcludable employees (a single health program may include only an indemnity plan and/or an HMO, as well as corresponding family coverages);

(2) The same employer subsidy must be provided to all nonexcludable employees; and

(3) The employer continues to meet the nondiscriminatory provision requirement. It is presumed that the nondiscriminatory provision requirement is not met if, in operation, only highly compensated employees receive meaningful coverage under the health program.

For purposes of determining whether the employer subsidy is the same with respect to each employee, a uniform flat dollar contribution toward the total premium for the plan or a uniform percentage of the premium will be permissible. The latter approach will allow for age-rating of the subsidy.

Uninsurable employees

For purposes of the general eligibility test and the alternative test, a small employer could disregard employees who are determined to be uninsurable (under customary and reasonable standards) by reason of a medical condition by the insurance company or HMO that provides core health coverage to the employees of the employer.

Determination of eligible employees

In determining the number of employees to whom coverage is required to be available under the eligibility test, an employer would be permitted to round down to the nearest number of employees (while this rule applies to all employers, it is expected to be particularly helpful in the case of small employers).

Calculation of premiums

A small employer would be permitted to use average premium cost even if the employer's premium is calculated on an individually rated basis.

Written plan requirement

For health plans, the written plan requirement under the qualification rules could be satisfied by a small employer by the insurance contract that is currently in effect relating to the coverage provided by the employer.

Leased employees

Under the possible modification, the application of the leased employee rules to section 89 would be delayed until plan years beginning after December 31, 1992, in order to afford an opportunity for the Secretary to address concerns that have been raised by employers. This delay would not be available in the case of certain individuals (e.g., nurses or secretaries) providing services to professionals.

Treatment of cafeteria plans

Under the possible modification, an employer that maintains at least one health plan funded through salary reduction contributions or otherwise maintains a cafeteria program (sec. 125) which includes one or more health plans would be permitted to elect to test all its health plans (whether or not funded through salary reduction) under an alternative test. The employer would be required to meet the nondiscriminatory provision requirement even if the alternative test is elected.

The alternative test would be satisfied if (1) employer-provided core health coverage is available to 90 percent of all employees (without regard to the application

of any affordability standards), and (2) the average employer-provided benefit received by the highly compensated employees under all health plans does not exceed 150 percent of the average employer-provided benefit received by nonhighly compensated employees.

Under the alternative test, family coverage would not be tested separately. However, family coverage would not be considered in determining the average coverage received by the nonhighly compensated employees unless the employer makes family core health coverage available to 90 percent of its employees. Family coverage elected by the highly compensated employees would always be considered in determining the average coverage received by the highly compensated employees.

In calculating the average benefits under the alternative test, all nonexcludable employees would be taken into account. Salary reduction contributions under the cafeteria program would be treated as employer-provided for purposes of this test.

If an employer elects to use this alternative rule, the limitations on employee contributions would not apply. If an employer elects to apply the alternative test, the election would apply to all the health plans of the employer (subject to the application of the separate line of business and operating unit rules). If the employer does not elect to use this rule, then the usual nondiscrimination rules apply with respect to all plans of the employer, including those rules relating to the treatment of salary reduction contributions.

Under the alternative test, if the 90-percent availability requirement is not satisfied, highly compensated employees would include the cost of all employer-provided coverage in taxable income. If the average benefit test is not satisfied, a highly compensated employee would include the cost of employer-provided coverage received in taxable income to the extent that such coverage exceeds, with respect to that employee, 150 percent of the average benefit of the nonhighly paid employees.

Former employees

The possible modification would provide that an employer could take into account only those former employees who meet certain reasonable eligibility requirements relating to age or service in determining whether benefits are provided to such employees on a nondiscriminatory basis. In addition, in applying the nondiscrimination tests to former employees, the mandatory employee contribution limits (i.e., both the 50-percent limitation and the special flat dollar limitations) would not apply.

Excludable employees

Part-time employees

Under the possible modification, employees who normally work less than 30 hours a week would be disregarded for purposes of the nondiscrimination tests.

Individuals participating in certain government-sponsored programs

Under the possible modification, the following individuals could be disregarded for purposes of determining whether the employer meets the nondiscrimination tests: (1) senior citizens employed pursuant to title V of the Older Americans Act or pursuant to the Environmental Programs Assistance Act of 1984; (2) students under certain programs qualified under title VIII of the Higher Education Act of 1965; (3) certain disabled individuals performing services at specified rehabilitation facilities; (4) inmates in state, local, or Federal correctional facilities; and (5) similar classes of individuals as designated by the Secretary.

Excludable employees provided with coverage

Under the possible modification, employees in an excludable group are disregarded. However, any highly compensated employee in that excludable group includes in taxable income the value of any coverage received that relates to the period of time for which the employee is excludable, unless the employer elects to test the excludable group with all of its employees. Thus, for example, if a highly compensated employee is provided coverage without any waiting period relating to service, but other employees are subject to a 6-month waiting period, then the value of the employee's first 6 months of coverage is included in his or her taxable income.

An employer could disregard excludable employees even if one or more excludable nonhighly compensated employees receive health coverage from the employer.

State and local governments

The possible modification would allow State and local government employers to apply the nondiscrimination tests separately to each administrative unit (e.g., a unit of government that has independent budgetary authority) in a manner similar to the rules relating to tax-deferred annuities (sec. 403(b)).

With respect to collectively bargained plans maintained by state and local governments, the rule relating to whether a unit of employees covered by the agreement contains more

than a de minimis number of professionals is modified. Under the modification, a unit will not be considered to contain more than a de minimis number of professionals if such unit is not comprised of more than 25 percent highly compensated employees.

There is also a delayed effective date with respect to plans maintained by state and local governments. See the discussion of the effective date of the rules discussed below.

Multiemployer plans

Under the possible modification, employees covered by multiemployer plans would be tested under a special rule. An employer would satisfy the nondiscrimination tests with respect to employees in a multiemployer plan if the plan certifies to the employer that: (a) the plan is affordable (i.e., meets the 50-percent limitation on employee contributions); and, (b) the eligibility standards under the plan satisfy the minimum eligibility standards under section 89 (i.e., the part-time employee definition, waiting periods, etc.). In certifying to (a) above, the plan would not be required to certify that it meets the affordability standards for employees with annual compensation less than $20,000.

If no certification is made, then those employees covered by the multiemployer plan who are highly compensated are required to include in income the contributions to the plan that the employer made on their behalf. Of course, as under present law, the determination of whether an employee is highly compensated is made on the basis of the employee's relationship with the employer.

Valuation

The possible modification would clarify the determination of value. In determining whether employee contributions required under a plan meet the affordability requirement (i.e., the 50-percent requirement), the employer would be required to use the cost of coverage as that cost is determined under the health care continuation rules.

For purposes of determining whether the 133-percent benefits requirement or the alternative average benefits test available to employers maintaining cafeteria programs is satisfied, the bill would make permanent the temporary valuation rule under present law.

Any employer-provided coverage received by a highly compensated employee in excess of the level of employer-provided coverage that meets the 133-percent benefits requirement or the alternative average benefits test available to employers maintaining cafeteria programs would

be includible in the taxable income of such employee, based upon the cost of such coverage as determined under the health care continuation rules.

Plans other than health plans

Group-term life insurance

The possible modification would provide that the nondiscrimination rules in effect (including any applicable grandfather rules) prior to the Tax Reform Act of 1986 apply to group-term life insurance for years beginning in 1989 (sec. 79(d)).

For years beginning after December 31, 1989, the nondiscrimination rules applicable to group-term life insurance would be modified to compare highly and nonhighly compensated employees, rather than comparing key and nonkey employees. In addition, the 1986 Act rule that provides that group-term life insurance is discriminatory to the extent it takes into account an employee's compensation in excess of $200,000 would be retained.

Dependent care assistance programs

Under the possible modification, for plan years beginning in 1989, the section 89 nondiscrimination requirements would not apply to dependent care assistance programs. Instead, the present-law nondiscrimination rules under section 129(d) would be applicable to such plans and would be modified so that only highly compensated employees are required to include benefits in gross income if a plan fails to meet the nondiscrimination requirements contained in section 129(d).

Accidental death and dismemberment

Under the possible modification, accidental death and dismemberment plans (AD&D) would be treated as group-term life insurance plans solely for purposes of nondiscrimination testing. Thus, a death benefit under an AD&D plan that is based on a uniform multiple of compensation (not in excess of the $200,000 limitation) would not be considered discriminatory solely because of the use of such multiple.

Qualification rules

Benefits excludable under section 132

Under the possible modification, the qualification rules apply to any plan the benefits under which are excludable under section 132 (i.e., no-additional-cost services, qualified employee discounts, and employer-provided eating facilities).

Excise tax on failure to comply with qualification rules

Under the possible modification, no penalty would be imposed with respect to a failure to satisfy the qualification rules if the employer corrects the failure to comply within 6 months of the date the employer knew or should have known of such failure. If the employer does not correct the failure within this 6-month period, then an excise tax would be imposed. The excise tax would equal 34 percent of the costs paid or incurred by the employer for coverage under the plan that relates to the failure. In the event of a willful failure to comply with the qualification requirements, the tax would be imposed from the date of the failure without regard to any subsequent correction.

Under the possible modification, the Secretary would be authorized to waive the excise tax in whole or in part if the failure is not due to willful neglect and to the extent the payment of the tax would be excessive relative to the failure involved. In the event the failure relates to a multiemployer plan, the excise tax would be imposed on the plan.

Effective dates

Under the possible modification, the nondiscrimination and qualification rules under section 89 would be delayed for one year. Thus, the new health nondiscrimination rules and all qualification rules would be effective for plan years beginning after December 31, 1989.

The amendment would also delay the nondiscrimination and qualification rules for collectively bargained plans. Under this delay, the requirements would not apply to a plan maintained pursuant to a collective bargaining agreement (with respect to employees covered by the agreement) until plan years beginning on or after the earlier of (1) the expiration of the collective bargaining agreement, or (2) January 1, 1993.

The possible modification would delay the nondiscrimination and qualification rules for plans maintained by State or local governments until plan years beginning after December 31, 1991.